

Message Text

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PAGE 01 BOGOTA 05931 01 OF 02 271928Z
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FM AMEMBASSY BOGOTA

TO SECSTATE WASHDC IMMEDIATE 2291

AMEMBASSY PARIS IMMEDIATE

LIMITED OFFICIAL USE SECTION 1 OF 2 BOGOTA 5931

E.O. 11652: N/A

TAGS: EAID, EFIN, CO

SUBJ: PROJECTED LEVELS OF EXTERNAL DEBT MAY THREATEN
COLOMBIAN ECONOMIC POLICY

REF: BOGOTA 5674

PARIS FOR USDEL TO IBRD - CONSULTATIVE GROUP ON COLOMBIA

SUMMARY: THIS TELEGRAM DISCUSSES THE IMPLICATIONS OF THE
EXTERNAL CREDIT SOUGHT BY COLOMBIA WHICH WILL BE DISCUSSED
AT THE CONSULTATIVE GROUP MEETING IN PARIS. IT IS THE
EMBASSY'S VIEW THAT HIGH LEVELS OF EXTERNAL BORROWING,
AT A TIME WHEN THE PRIMARY PROBLEM IN THE COLOMBIAN
ECONOMY IS EXCESS DOLLAR INFLOW, ARE NOT ONLY UNNECESSARY
BUT RISK UNDERMINING MUCH OF THE HEALTHY EVOLUTION OF THE
COLOMBIAN ECONOMY WHICH HAS TAKEN PLACE OVER THE LAST TEN
YEARS.

1. LARGE EXTERNAL BORROWING AT THIS TIME WILL STRENGTHEN

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PAGE 02 BOGOTA 05931 01 OF 02 271928Z

RECENT NEGATIVE TRENDS, EXACERBATE INFLATION AND COULD
LEAD COLOMBIA BACK TOWARD AN ECONOMY EXCESSIVELY DEPENDENT
UPON A FEW BASIC COMMODITY EXPORTS. MOREOVER, WE BELIEVE
THAT LARGE BORROWING WILL LEAD TO A SERIES OF STRUCTURAL
DISTORTIONS THAT WILL EVENTUALLY REDUCE FOREIGN EXCHANGE
AVAILABILITY AND THUS MAKE THE BORROWING NECESSARY. THERE
IS AN ALTERNATIVE THAT SHOULD NOT, IN ANY WAY, HINDER FIN-

ANCING OF THE MAJOR PROJECTS BEING PRESENTED TO THE
CONSULTATIVE GROUP.

2. THE WORLD BANK STUDY PREPARED FOR THE CONSULTATIVE
GROUP PROJECTS NET BORROWING OF \$2.5 BILLION TO BE SPENT
FOR THE FOREIGN EXCHANGE COSTS OF MAJOR, HIGH PRIORITY,
PRIVATE AND PUBLIC PROJECTS. THE REPORT STATES, AND THE
COLOMBIAN GOVERNMENT CONCURS, THAT COMESTIC SAVINGS ARE
INADEQUATE TO FINANCE THESE PROJECTS. BUT THE SAME
REPORT PROJECTS COLOMBIAN INTERNATIONAL RESERVES GROWING
BY \$2.4 BILLION IN THE SAME PERIOD. THIS MEANS THAT
COLOMBIA IS IN EFFECT BORROWING TO PLACE FOREIGN EX-
CHANGE INTO RESERVES. THAT IS, THEY ARE BORROWING AT
8 TO 10 PERCENT TO PLACE ALL BUT \$100 MILLION IN U.S.
T-BILLS OR DEUTSCHE MARKS AT 4 TO 6 PERCENT.

3. THE WORLD BANK AND COLOMBIAN GOVERNMENT POSITION
IS THAT DOMESTIC SAVINGS ARE INADEQUATE AND, HENCE,
THE COUNTRY MUST BORROW TO FINANCE THESE PRMJECTS.
HOWEVER, SINCE RESERVES WILL GROW BY ALMOST THE SAME
AMOUNT AS THE BORROWING, AND ARE ALREADY HIGHER THAN
THEY NEED TO BE, THE COUNTRY POSSESSES ADEQUATE SAVINGS.
RESERVES ARE CLAIMS ON THE WORLD'S REAL RESOURCES AND
ARE SAVINGS. THE GOVERNMENT POSITION IS THAT RESERVES
DO NOT BELONG TO THE GOVERNMENT AND THAT THERE ARE
INSUFFICIENT PUBLIC PESOS TO BUY THE RESERVES. MOREOVER,
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PAGE 03 BOGOTA 05931 01 OF 02 271928Z

THE PROJECTS REQUIRE LONG TERM FINANCING, AND PESO
FINANCING IS PRACTICALLY ALL SHORT TERM. HOWEVER, THE
\$2.4 BILLION INCREASE IN RESERVES WILL LEAD TO A \$2.4
BILLION TIMES THE EXCHANGE RATE INCREASE IN THE MONEY
SUPPLY. THE INCREASE WILL BE INFLATIONARY AND THE
GOVERNMENT WILL TRY TO CONTROL THE SECONDARY MONETARY
EXPANSION BY RAISING LEGAL RESERVE REQUIREMENTS, ETC.
AT PRESENT, THERE IS A 46 PERCENT LEGAL BANK RESERVE
REUEMENT AND A 100 PERCENT MARGINAL RESERVE REQUIRE-
MENT, AND OVER 46 BILLION PESOS FROZEN IN LEGAL RESERVES.
WERE THE RESERVE REQUIREMENT LOWERED TO 10 PERCENT, SOME
35 BILLION PESOS WOULD BECOME AVAILABLE TO BE CAPTURED
IN GOVERNMENT INSTRUMENTS THROUGH OPEN MARKET OPERATIONS.
THUS, LARGE GOVERNMENT BORROWING COULD BE ACCOMPLISHED
WITHOUT CAUSING A SIGNIFICANT INCREASE IN INTEREST RATES.
MOREOVER, REDUCED RESERVE REQUIREMENTS WOULD REDUCE BANKING
COSTS, INCREASING THE SPREAD RECEIVED BY BANKS, RAISING
PROFITS AND INDUCING BANKS TO COMPETE FOR FUNDS BY RAISING
THEIR INTEREST RATES ON CD'S AND SAVINGS WITHOUT INCREASING
THEIR LENDING RATES. THE INCREASED INTEREST RATES WOULD
INDUCE ADDITIONAL SAVINGS. IN COLOMBIA THERE SEEMS TO
BE A VERY HIGH ELASTICITY OF FINANCIAL SAVINGS TO

CHANGES IN INTEREST RATES. REAL SAVINGS MAY BE LESS ELASTIC, BUT GIVEN THE EXISTENCE OF A LARGE EXTRA BANK MARKET, THERE ARE TRANSFERS FROM THE EXTRA BANK MARKET TO THE VISIBLE BANK MARKET WHEN INTEREST RATES INCREASE. A TWO TO FOUR POINT INCREASE IN SAVINGS RATES SHOULD LEAD TO A MINIMUM INCREASE IN FINANCIAL SAVINGS OF 5 TO 10 BILLION PESOS, WHICH COMBINED WITH THE 35 BILLION PESOS RELEASED FROM LEGAL RESERVES (NOT TO MENTION SAVINGS GENERATED BY THE RESULTING REAL AND NOMINAL GROWTH) IS MORE THAN SUFFICIENT TO FINANCE THE FIRST YEAR'S FOREIGN EXCHANGE COSTS OF THE PROJECTS.

4. THE DIFFERENCE BETWEEN USING RESERVES AND BORROWING DOLLARS IS MORE THAN MERELY BOOKKEEPING AND A FEW POINTS LIMITED OFFICIAL USE

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PAGE 04 BOGOTA 05931 01 OF 02 271928Z

OF INTEREST. THE DIFFERENCE AT THIS POINT IN TIME IS STRUCTURALLY AND POLITICALLY VERY IMPORTANT. IF DOLLARS ARE BORROWED INSTEAD OF PESOS, THE RESERVES WILL CONTINUE THEIR RAPID GROWTH. THE MONEY SUPPLY WILL CONTINUE TO EXPAND, REQUIRING RESTRICTIVE MONETARY POLICIES, RAISING THE COSTS OF CREDIT AND HINDERING INVESTMENT. MORE IMPORTANTLY, WITH THE EXCESS SUPPLY OF DOLLARS IT WILL BE DIFFICULT TO DEVALUE THE PESO AT A RATE COMMENSURATE WITH THE RATE OF INFLATION. GIVEN THE HIGH RATES OF INFLATION, THE REAL EFFECTIVE EXCHANGE RATE WILL CONTINUE TO INCREASE. MINOR EXPORTS WILL BE AFFECTED ADVERSELY AND CONSUMER GOODS IMPORTS WILL INCREASE, THUS RAISING PROTECTIONIST PRESSURES. A FROZEN PESO OR A SLOW MOVING PESO WHICH RESULTS IN A REAL EFFECTIVE REVALUATION WILL LEAD TO CAPITAL INFLOWS THROUGH THE SERVICE WINDOW, ADDING TO THE MONEY SUPPLY. IT WILL BE NECESSARY TO LOWER INTEREST RATES TO HALT THE CAPITAL INFLOW AND TO STIMULATE LAGGING INVESTMENT. WITH THE DECREASE IN SAVINGS RESULTING, FURTHER SPECIAL LINES OF CREDIT AND OTHER MONETARY COMPLICATIONS WILL BE CREATED.

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PAGE 01 BOGOTA 05931 02 OF 02 271941Z
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LIMITED OFFICIAL USE SECTION 2 OF 2 BOGOTA 5931

5. TO MAINTAIN MINOR EXPORT GROWTH THE RECENTLY CREATED DUAL EXCHANGE RATE WILL HAVE TO BE GRADUALLY INCREASED UNTIL THE SPREAD IS ENORMOUS AND DISTORTING, OR A VERY LARGE EXPORT SUBSIDY WILL BE NECESSARY. A LARGE EXPORT SUBSIDY WILL NOT ONLY LEAD TO COUNTERVAILING DUTY PROBLEMS WITH THE UNITED STATES BUT WILL RETURN PUBLIC FINANCES TO THE SORRY STATE THAT EXISTED PRIOR TO THE 1974 TAX REFORM. MOREOVER, THE LARGE AND GROWING EXTERNAL DEBT WILL PRESENT A PESO FINANCING PROBLEM IN THE 1980'S WHEN LOWER COFFEE PRICES, SLUGGISH MINOR EXPORTS AND GROWING PETROLEUM IMPORTS WILL REQUIRE A STRONG DEVALUATION, BUT EACH PESO OF DEVALUATION WILL ADD A PESO TO THE COST OF AMORTIZING DEBT AND IMPORTING THE PETROLEUM. GOVERNMENTS WILL FIND DEVALUATION MORE NECESSARY BUT MORE DIFFICULT, AND WILL PROBABLY CONTINUE TO BORROW EXTERNALLY TO PUT OFF THE MORE DIFFICULT STEPS.

6. IN SHORT, WE ARE DESCRIBING CREEPING IMPORT SUBSTITUTION. IT SHOULD BE EMPHASIZED THAT MOST OF THE LIMITED OFFICIAL USE

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PAGE 02 BOGOTA 05931 02 OF 02 271941Z

RECENT ECONOMIC GROWTH IN COLOMBIA IS DIRECTLY ATTRIBUTABLE TO THE MOVE AWAY FROM IMPORT SUBSTITUTION AND TOWARDS EXPORT-LED GROWTH. STRONG MINOR EXPORT GROWTH SINCE 1967 HAS BEEN THE PRIMARY SOURCE OF THE RAPID GROWTH OF EMPLOYMENT (FACTORY EMPLOYMENT WHICH INCREASED BY 3.2 PERCENT A YEAR DURING THE TWO DECADES PRECEDING 1967 ROSE TO 7 PERCENT YEARLY GROWTH FROM 1967 TO 1974). THE EXPORT GROWTH HAS INCREASED AGRICULTURAL OUTPUT, AND HAS BEEN THE SOURCE OF IMPROVING INCOME DISTRIBUTION (A WORLD BANK STUDY SHOWED COLOMBIA FROM THE MID-SIXTIES UNTIL RECENTLY AS ONE OF THE VERY FEW COUNTRIES WHERE INCOME DISTRIBUTION WAS IMPROVING). POLITICALLY, MINOR EXPORT GROWTH HAS MEANT A LESS CONCENTRATED AND MORE

DIVERSIFIED ECONOMY, A GROWING MIDDLE CLASS, AND A PROMISE OF INDEPENDENCE FROM COFFEE AND THE DEEP CYCLICAL SWINGS SUCH DEPENDENCE IMPLIES. IT HAS OFFERED HOPE FOR LIBERAL REFORM TOWARDS LESS CONTROLLED, FREER AND, HENCE, LESS CORRUPT ECONOMIC INSTITUTIONS.

7. THE EMBASSY ESTIMATES THE ELASTICITY OF MANUFACTURES AND NON-COFFEE AGRICULTURAL EXPORTS AT A HIGH 2.6. EVEN IF WORLD TRADE CONTINUES TO GROW AT RECENT RATES, OUR ESTIMATES SHOW THAT COLOMBIAN MINOR EXPORTS WILL DECLINE IN 1977 AND DECLINE SHARPLY IN 1978. THERE IS AT LEAST A YEAR'S LAG BETWEEN CHANGES IN THE EFFECTIVE EXCHANGE RATE AND CHANGES IN MINOR EXPORTS, SO THE ECONOMY WILL NOT FULLY PERCEIVE THE DAMAGE UNTIL IT IS ALREADY DONE. THE REAL EFFECTIVE EXCHANGE RATE HAS BEEN INCREASING, AND THE RATE OF GROWTH OF MINOR EXPORTS DECLINING SINCE 1971. THE EFFECTIVE REAL REVALUATION WILL BE SHARP THIS YEAR, SO THAT MUCH DAMAGE HAS ALREADY BEEN DONE. IF COLOMBIA CONTINUES TO COMBINE HIGH INFLATION WITH SLOW (OR NO) DEVALUATION THE LIMITED OFFICIAL USE

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PAGE 03 BOGOTA 05931 02 OF 02 271941Z

DETERIORATION WILL ACCELERATE AND IF COLOMBIA BORROWS THE AMOUNTS PROJECTED MVER THE NEXT FEW YEARS IT WILL BE NEXT TO IMPOSSIBLE TO KEEP THE EFFECTIVE EXCHANGE RATE FROM REVALUING.

8. CONSIDER THE ALTERNATIVE. WERE COLOMBIA TO OBTAIN COMMITMENTS FROM THE LENDERS IN PARIS, INSTEAD OF LOANS THAT MUST BE DISPERSED, THEN AS LONG AS RESERVES TENDED TO GROW THE GOC COULD BORROW PESOS BY ISSUING BONDS, THUS CAPTURING THE PESOS MADE AVAILABLE BY LOWERING RESERVE REQUIREMENTS ON BANKS, AND CAPTURING THE PESOS THAT WOULD BE GENERATED BY INCREASED INTEREST RATES PAID TO SAVERS. THESE PESOS COULD BE USED BY THE GOVERNMENT TO BUY DOLLARS FROM THEIR OWN RESERVES TO FINANCE THE INITIAL DOLLAR COSTS OF THE PROJECTS. SINCE RESERVES WOULD BE DECLINING, THE MONEY SUPPLY WOULD BE CONTRACTING. THERE WOULD NO LONGER BE AN EXCESS SUPPLY OF DOLLARS AND THE PESO DEVALUATION COULD PROCEED IN RELATION TO INFLATION, WHICH WOULD IN TURN BE DECLINING. IF RESERVES BEGIN TO DECLINE TOO RAPIDLY THEN SOME OF THE LOAN COMMITMENTS CMULD BE ACTIVATED AND COLOMBIA COULD BEGIN TO BORROW. THE NET RESULT WOULD BE HEALTHY MINOR EXPORT GROWTH (AND MORE RAPID GROWTH OF EMPLOYMENT), A LOWER EXTERNAL DEBT, REDUCING THE PESO COST OF THE FUTURE AMORTIZATIONSN AND EASING FUTURE BUDGET PRESSURE. MOREOVER, THE PROTECTIONIST PRESSURE WOULD BE CONTROLLED BY THE FASTER DEVALUATION, AND INTEREST RATES COULD REMAIN

HIGH, THEREBY CAPTURING GREATER SAVINGS AND ALLOCATING
THEM TOWARD HIGHER YIELDING AND MORE EMPLOYMENT
GENERATING INVESTMENTS.

9. WHILE ALL OF THIS SOUNDS RATHER COMPLICATED AND
THEORETICAL, IT IS BASICALLY SIMPLE AND IT IS REAL.
THE UNITED STATES, AS AN IMPORTANT MEMBER OF THE
BOARDS OF THESE LENDING INSTITUTIONS, SHOULD MAKE
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PAGE 04 BOGOTA 05931 02 OF 02 271941Z

ITS CONCERNS KNOWN TO THE LENDERS AND TO THE
COLOMBIAN DELEGATION. SINCE THE WORLD BANK STUDIES
ARRIVED LATE AND IN THE MIDST OF MRS. CARTER'S VISIT
WE DID NOT HAVE TIME TO TEST OUR VIEWS EMPIRICALLY
OR TO DISCUSS OUR CONCLUSIONS WITH THE MEMBERS OF
THE COLOMBIAN DELEGATION PRIOR TO THEIR DEPARTURE.
IT IS OUR IMPRESSION, HOWEVER, THAT THESE POINTS HAVE
NOT BEEN CONSIDERED BY THE COLOMBIANS, BUT WILL BE IF
RAISED IN THE PROPER CONTEXT IN PARIS. THE POINTS
SHOULD BE DISCUSSED INFORMALLY WITH HERNAN MEJIA, WHO
IS ONE OF THE FEW ECONOMISTS TO WHOM FINANCE MINISTER
ABDON ESPINOSA LISTENS. WE BELIEVE THAT MEJIA WILL
BE RECEPTIVE TO THESE SUGGESTIONS.
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